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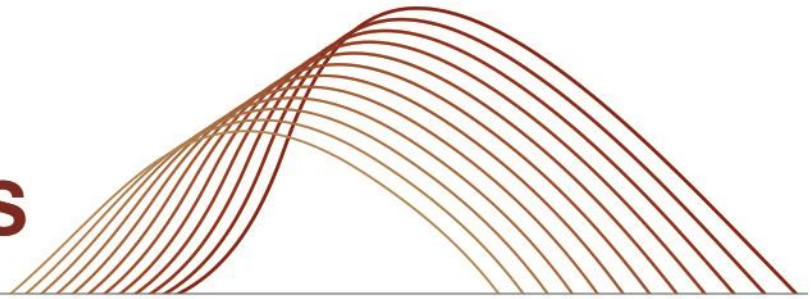

October 2017

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CFIUS, China Deals and the Trump Administration: Five Things to Know

By Scott M. Flicker

In March 2016, we warned of a coming showdown between the U.S. and China arising out of the perception that the Committee on Foreign Investment in the United States ("CFIUS") was unfairly restricting Chinese deals in a process that was neither objective nor transparent.[1] Our prediction of heightened tensions borne of an increasing flow of Chinese investment targeting ever more sensitive companies and technology was correct. Some high-profile deals (such as ChemChina/Syngenta) did win CFIUS clearance in 2016, but the year ended on a dramatic note, when President Obama issued an order blocking a Chinese investor from completing a tender offer for shares of a German semiconductor equipment manufacturer on the grounds that the change in indirect ownership of the target's U.S. business was adverse to U.S. national security.[2]

What we did not predict was the outcome of the November 2016 U.S. election, ushering in an administration and a Congress willing to recast CFIUS as a tool of bilateral trade and foreign policy in an overt effort to counter a perceived threat that the Chinese government is engaged in a high-tech, modern version of mercantilism or simply to pressure China to support other U.S. strategic goals. The CFIUS process was designed to be neither a protectionist barrier nor a blunt force policy lever, and any attempt to deploy it in this way will create significant distortions in the U.S. investment landscape, upsetting the delicate balance that must constantly be struck between the need to remain open to diverse sources of investment capital while protecting legitimate U.S. national security interests.

That balance shows signs of tipping, and for those operating in any segment focused on outbound China investment there are at least five things to know:

Thing 1: The Number of China Deals That Will Fail Due to CFIUS Will Increase.

So far, 2017 has seen the failure of a number of Chinese deals due to CFIUS resistance or rejection, most prominently President Trump's recent order scuttling Canyon Bridge's proposed investment in Lattice Semiconductor. Reports indicate that more than a half-dozen proposed Chinese takeovers are cycling through multiple rounds of withdrawals and refilings before CFIUS, as the parties and the Committee continue to explore whether there are grounds for clearance (including approval with mitigation). Meanwhile, more deals continue to be filed on a weekly basis. While some of these new or pending transactions will clear through the process, the year is shaping up as one in which more China transactions may fail or be rejected than are approved.

Thing 2: Perception Is Becoming Reality.

Paradoxically, as the CFIUS barrier began to figure more prominently in cross-border investment planning—spurred by the increasing number of high-profile deals being rejected—*more*, not fewer, China deals were being filed for review. The parties and advisers to a transaction with any potential sensitivity often concluded that the substantial risk of CFIUS intervention could not be disregarded, but rather had to be addressed head on by presenting the facts to the Committee and making the best arguments in favor of clearance. Many of these transactions pose little real national security threat, but in some cases, it is a tougher call. Coupled with the general rise in China outbound M&A seen in the last half of 2016 and the first quarter of 2017, the increase in filings quickly threatened to overload the CFIUS staff. When further combined with the lack of clear policy direction that resulted from an especially slow transition for the new administration, CFIUS found itself unable to clear even unremarkable Chinese cases from its docket. The picture is turning darker, not lighter. The lack of policy direction is being resolved, but in a way that suggests CFIUS reviews of Chinese-led transactions will be viewed through a protectionist lens. According to recent reports, the White House is conducting a comprehensive review of the U.S.-China strategic and economic relationship, a development that could easily increase scrutiny over Chinese investments in the U.S., particularly those seen as motivated by Beijing's sector-specific industrial policy. The result is a perception—becoming reality—that CFIUS is growing more biased against Chinese deals.

Thing 3: More Deals Will Be Structured to Fall Outside CFIUS' Jurisdiction.

One reaction to a CFIUS process that is seen as a killing ground for Chinese deals is that more transactions will be structured to fall outside the scope of CFIUS' review jurisdiction, arguably weakening its effectiveness as a national security gatekeeper. Section 721 of the Defense Production Act of 1950 (the statute under which CFIUS operates) applies to "any merger, acquisition, or takeover . . . by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States."[3] The concept of "control" is not defined; Congress conferred upon CFIUS the discretion to give the term whatever meaning it deemed fit to accomplish its mission.[4] Seeking to preserve its jurisdiction to the maximum extent, CFIUS promulgated a definition of "control" that looks far beyond legal or formalistic concepts such as holding the majority of voting shares in an entity. Instead, "control" can include "any power," direct or indirect, "whether or not exercised," and whether acquired through "the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity," contractual arrangements, "formal or informal arrangements to act in concert," or "other means," to "determine, direct, or decide important matters" affecting the entity.[5] Applying this "facts and circumstances" test, CFIUS has found "control" can exist in acquisition of a minority voting share, securing of a board seat, and even holding a non-voting stake if it carries some potential that the investor can exercise sufficient influence over management to direct affairs at the target.

Foreign investors are looking increasingly to alternative capital structures in a bid to put their deals out of reach of this extremely broad and amorphous concept of "control." As the failed Canyon Bridge–Lattice transaction makes clear, simply relying on ordinary private equity fund structures, especially when the limited partner financing is supplied by a Chinese state-owned enterprise, has proven insufficient to avoid an adverse CFIUS outcome. More exotic alternatives to classic mergers, acquisitions, and takeovers might meet with more success, including offshore joint ventures, technology licensing schemes, debt instruments that behave like equity, or other long-term contractual arrangements to lock in revenue streams and provide a return on investment, although the non-public nature of CFIUS cases means that parties will always be operating with imperfect

information when seeking guidance on how to manage CFIUS risk by avoiding its jurisdiction altogether.

Thing 4: The U.S. Congress Might Counteract Thing 3.

Efforts to structure transactions beyond the scope of CFIUS' jurisdiction may swiftly be rendered moot by recent initiatives in the U.S. Congress to amend the Defense Production Act to cover more forms of foreign investment in U.S. businesses. Among the potential areas of expansion are more CFIUS scrutiny of real estate transactions, extension of review authority to cover technology licensing arrangements, and heightened restrictions on transactions backed by governments deemed to be strategic rivals of the United States. The powerful sponsors of these efforts, including Senate Majority Whip John Cornyn of Texas, make no secret of the fact that they are acting to counteract a perceived threat that Chinese companies (backed by the Chinese government) are targeting sensitive U.S. technologies and assets. The last major expansion of the CFIUS statute came in 2007, in the wake of the political firestorm that resulted from approval of a bid for Dubai Ports World to acquire a U.K. with U.S. port assets. While the current effort is in the earliest stages, we predict it will gain steam and ultimately lead to some form of legislation increasing CFIUS' power to review Chinese transactions.

Thing 5: The United States' Loss May Be the Rest of the World's Gain—Or Not.

Another consequence of the increasing restriction being imposed on Chinese investment in the U.S. is growing attention on assets and targets outside the United States. Immediately after President Trump's order blocking the Lattice deal, Canyon Bridge announced a £550 million agreement to acquire Imagination Technologies, a U.K. company with graphics and video processing technology that it licenses to device manufacturers, including Apple. Reports indicate that the U.S. business assets of Imagination will be divested prior to the closing to avoid CFIUS jurisdiction. But this focus by Chinese companies on technology investments outside the United States also carries the seeds of a backlash. Last year, both Germany and the United States cleared the way for the acquisition of German robotics company KUKA AG by Midea Group, a Chinese firm. That deal, along with the failed Aixtron acquisition, sparked concerns in Germany that its leading edge in engineering and industrial manufacturing would be eroded by technology transfers to China. It comes as no surprise, then, that the European Union recently announced a proposal to devise its own framework for screening foreign investments in Europe, on grounds of security and "public order."[6]

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Now more than ever, Chinese parties looking to engage in outbound investment in the United States and elsewhere must be prepared to navigate an increasingly difficult political and regulatory environment in which not only the economic, but also the strategic motives of cross-border transactions are being carefully scrutinized. In this climate, a high degree of knowledge, planning, and preparation may be the only pathway to success.

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[1] *"CFIUS and China: Is This the Year of the Big Showdown?"* by Scott M. Flicker and Joanne Joseph, Paul Hastings Stay Current March 4, 2016, available here: https://www.paulhastings.com/publications-items/details/?id=96a7e869-2334-6428-811c-ff00004cbded.

[2] *"Regarding the Proposed Acquisition of a Controlling Interest in Aixtron SE by Grand Chip Investment GmbH,"* Presidential Order, 81 Fed. Reg. 88607 (Dec. 7, 2016). (Paul Hastings was counsel for Grand Chip in that transaction.)

[3] 50 U.S.C. App. § 2170(a)(3).

[4] *Id.,* § 2170(a)(2)("The term 'control' has the meaning given to such term in regulations which the Committee shall prescribe.").

[5] 31 C.F.R. § 800.204(a).

[6] *See* http://europa.eu/rapid/press-release_IP-17-3183_en.htm.